No. 10,810

In the United States Circuit Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

LAWRENCE R. GREEN, RESPONDENT

On petition for review of the decision of The Tax Court of the United States

Brief for the Respondent

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OPINIONS BELOW

Before The Tax Court of the United States, the case of Ralph J. Green, brother of taxpayer, which case involved the same issues, was consolidated with the case of Lawrence R. Green for opinion, and the opinions of The Tax Court (R. 20-34) are reported in 3 T. C. 74. The Commissioner appealed to the Eighth Circuit regarding the case of Ralph J. Green, and that appeal is pending.

JURISDICTION

This case involves the taxpayer's income tax liability for the calendar year 1939. The decision of the Tax Court was entered on February 16, 1944 (R. 39), and the petition for review was filed on May 5, 1944 (R. 66-72). The juris-

diction of the Court rests upon Sections 1141-1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

The taxpayer was transferee of the estate of his deceased father. In 1939 he received considerable gross income from assets previously received by distribution from this estate, and also paid a deficiency in estate tax, with interest thereon, assessed by the Commissioner with respect to the estate.

(a) Is the taxpayer entitled to a deduction under Sec. 23 (b) of the Internal Revenue Code for the interest so paid?

(b) Or, in the alternative, if it should be held that in paying the estate tax and interest the taxpayer was paying indebtedness of the estate or trust, and was not paying interest on his indebtedness, should the gross income of taxpayer for 1939, derived from assets previously distributed from the estate, be reduced by the interest paid for the estate or trust, resulting from distribution of the estate?

STATUTES INVOLVED

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *

* * * * *

SEC. 162. NET INCOME.

The net income of the estate or trust shall be

computed in the same manner and on the same basis as in the case of an individual, except that—

* * * * *

(c) In the case of income received by estates of deceased persons during the period of administration or settlement of the estates, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduction shall be included in computing the net income of the legatee, heir, or beneficiary; * * *

Internal Revenue Act of 1926:

Sec. 316 (Now Code Sec. 900)

Sec. 316 (a) The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of deficiency in a tax imposed by this title (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

(1) The liability, at law or in equity, of a transferee of property of a decedent or a donor, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed by this title or by any prior estate tax Act or by any gift tax Act.

(e) As used in this section the term "transferee" includes heir, legatee, devisee, and distributee.

Sec. 315 (Now Code Sec. 827)

Sec. 315 (a) Unless the tax is sooner paid in full, it shall be a lien for ten years upon the gross estate of the decedent, except that such part of the gross estate as is used for the payment of charges against the estate and expenses of its administration, allowed by any court having jurisdiction thereof, shall be divested of such lien.***

NOTE. The decedent died in 1930. The Revenue Act of 1926, as amended, controlled the affairs of the estate. The pertinent sections of the Revenue Act of 1926 were enacted with practically no change in the Internal Revenue Code.

Revised Statutes:

Sec. 3467 (Comp. Sts. 1916, Sec. 6373) Every executor, administrator, or assignee, or other person, who pays any debts due by the person or estate from (for) whom or for which he acts, before he satisfies and pays the debts due to the United States from such person or estate, shall become answerable in his own person and estate for the debts so due to the United States, or for so much thereof as may remain due and unpaid.

STATEMENT OF FACTS

The statement of facts contained in the brief of the Commissioner is correct.

SUMMARY OF ARGUMENT

I. The taxpayer paid interest on his own indebtedness and is entitled to the claimed deduction under Section 23 (b) of the Internal Revenue Code.

(a) The interest paid with respect to an estate tax deficiency is *interest* and not a part of the principal of the tax.

I. T. 1317, C. B., I-1, p. 132 *Boies Penrose* vs. *United States,* 18 Fed. Supp. 413.

(b) An estate tax deficiency is indebtedness under Section 23 (b), I. R. C.

W. S. Gilman vs. *Commissioner,* 18 B.T.A. 1277.

Fall River Electric Light Co. vs. *Commissioner,* 23 B.T.A. 168

Sterling Morton vs. *Commissioner,* 38 B.T.A. 1270

William Park vs. *Commissioner,* 38 B.T.A. 1118

Treasury Decision 4777, Cum. Bull, 1937-2 p. 196.

(c) A transferee of an estate is a substituted taxpayer, or at least a substituted debtor, and an unpaid estate tax becomes the liability and indebtedness of the transferee, especially after the estate has been distributed and has no assets to pay the tax.

Phillips vs. *Commissioner,* 283 U.S. 589.

Louisiana and Arkansas Railway Co. vs. *Commissioner,* 70 Fed. (2d) 286.

Routzahn vs. *Tyroler,* 36 Fed. (2d) 208 (C.C.A. 6).

United States vs. *Updike,* 281 U.S. 489, 496.

John H. Hord vs. *Commissioner,* 95 Fed. (2d) 179.

Estate of John Edgerly Morrell vs. *Commissioner,* 43 B.T.A. 651.

Boies Penrose vs. *United States,* 18 Fed. Supp. 413.

Robert P. Scripps, et al, Trustee, vs. *Commissioner,* 96 Fed. (2d) 492.

Harvey M. Toy vs. *Commissioner,* 34 B.T.A. 877.

Koppers Company vs. *Commissioner,* 3 T.C. 62, on appeal C.C.A. 3.

Breyer vs. *Commissioner,* T.C. Memorandum Opinion, January 20, 1944, on appeal C.C.A. 3.

Estate of Henderson vs. *Commissioner,* T.C. Memorandum Opinion, December 14, 1943, on appeal C.C.A. 5.

Collins vs. *Commissioner,* T.C. Memorandum Opinion March 13, 1944, on appeal C.C.A. 9.

Harold F. Pitcairn, et al vs. *Commissioner,* T. C. Memorandum opinion, May 22, 1944.

(d) If the operation of law did not make the taxpayer herein a substituted taxpayer regarding estate taxes, but only made him a substituted debtor, he should still be allowed to deduct the full amount of interest paid.

Columbia River Paper Mills vs. *Commissioner,* 43 B.T.A. 104, Affd. 126 Fed. (2d) 1009 (C.C.A. 9).

Oregon Pulp & Paper Co. vs. *Commissioner,* 47 B.T.A. 772, Petition for Review dismissed November 2, 1943.

Ernst Kern Co. vs. *Commissioner,* 1 T.C. 249, Petition for Review dismissed (nolle prosse) September 11, 1944.

Pressed Steel Car Co., Inc., vs. *Commissioner,* T.C. Memorandum Opinion, August 16, 1944.

(e) The liability of a transferee may be more than the value of transferred assets plus actual accumulated earnings thereon.

Henry Capellini vs. *Commissioner,* 16 B.T.A. 802.

Wayne Body Corporation vs. *Commissioner,* 24 B.T.A 524.

Buzard et al vs. *Helvering,* 77 Fed. (2d) 391.

(f) "Indebtedness" under Section 23 (b) of the Internal Revenue Code is not necessarily restricted to liabilities originated by the taxpayer, or with respect to which collection may be enforced from any property owned by him.

Scripps et al vs. *Commissioner,* 96 Fed. (2d) 492.

Penrose vs. *United States,* 18 Fed. Supp. 413.

New McDermott, Inc., vs. *Commissioner,* 44 B.T.A. 1035.

Agnes I. Fox vs. *Commissioner,* 43 B.T.A. 895.

House Com. Rep. No. 2333, 77th Cong., 1st Sess., Cum. Bull. 1942-2, 372, 495.

(g) Taxpayer was Executor of his father's estate and as such he was personally liable under Section 3467 R.S. in addition to being liable as a transferee.

Rev. Stats. Sec. 3467.

(h) Taxpayer was reporting on a cash basis and should deduct full accrual of interest when paid.

Street & Smith Publication, Inc. vs. *U. S.,* 38 Fed. Supp. 461.

G. C. M. 9575 X-1 C.B. 381.

I. T. 3491 1941-2 C.B. 177.

I. T. 2210 IV-2 C.B. 43.

(i) Interest received by a transferee with respect to a refund of estate taxes would be taxable income of transferee, and not receipt of non-taxable principal of estate; the same rules should govern the payment of interest on a deficiency.

II. On the trust fund theory, the gross income of taxpayer should be reduced by the amount of interest paid with respect to the estate, or any trust arising from the distribution of the estate.

(a) If, under the so-called "trust fund doctrine" a transferee taxpayer, when paying an estate tax deficiency and interest, is only paying the liability of the estate instead of his indebtedness and interest, and therefore he can not deduct the interest himself, then taxpayer's gross income for 1939, derived from the trust of properties transferred from the estate, should be reduced by the interest paid for the estate in 1939.

Koch vs. *U. S.,* 138 Fed. (2d) 850.

I.

THE TAXPAYER PAID INTEREST ON HIS OWN INDEBTEDNESS

(a) **The interest paid with respect to an estate tax deficiency is interest and not a part of the principal of the tax.**

Since 1922, at which time I.T. 1317, C.B. I-1, p. 132 revoked O.D. 594 (C.B. 3, p. 142), it has been the law that interest paid on an overdue Federal Income Tax constituted an allowable deduction on income tax of the estate and that the interest was interest and was not a part of the principal of the tax.

This is true although the interest so paid by the estate is collected under Section 891 of the Internal Revenue Code as a part of the tax. A transferee is merely a substituted taxpayer by reason of Section 316, Revenue Act of 1926. He pays an estate tax deficiency with interest added as a part of the tax. There is no more reason to say that the interest added to tax and paid by a transferee is a part of the tax, and therefore is not interest, than there is to make the same claim with respect to similar interest paid by an estate.

Section 308 (h), Revenue Act of 1926 (now Code Sec. 891) provides that the interest on a deficiency is being assessed at the same time as the deficiency "and shall be collected as a part of the tax." The law further provides a somewhat elaborate procedure for collection of the tax including jeopardy assessments and filing of liens against property. Any interest on a deficiency is to be collected as interest. If the foregoing quoted portion of the law changed

interest into a tax, then the estate could not deduct any such amount as interest. The law would apply equally as well to the estate as to the transferee. There is no more reason to say that interest is added to the tax paid by the transferee and therefore is a part of the tax than there would be to make a similar claim with respect to interest on an estate tax deficiency paid by an estate before its distribution.

In *Penrose* vs. *U. S.*, 18 Fed. Supp. 413, the Court decided that interest added to the tax was interest paid on indebtedness and not a part of the estate tax.

(b) An estate tax deficiency is indebtedness under Section 23 (b).

The word *indebtedness* as used in Section 23 (b) is not defined in the statute. However, the Board of Tax Appeals and the courts have defined indebtedness in this connection as something owed in money which one is unconditionally obligated or bound to pay, the payment of which is enforceable. *Park* vs. *Commissioner*, 38 B. T. A. 1118, *Gilman* vs. *Commissioner*, 18 B. T. A. 1277: which was followed in *Morton* vs. *Commissioner*, 38 B. T. A. 1270. In *Fall River Electric Light Company* vs. *Commissioner*, 23 B. T. A., 168, interest is defined as "the compensation allowed by law or fixed by the parties for the use, or forebearance, or detention, of money." In T. D. 4777, C. B. 1937-2, p. 196 the Commissioner defined indebtedness with respect to personal holding companies: "The term 'indebtedness' means on obligation, absolute and not contingent, to pay, on demand or within a given time, in cash or other medium, a fixed amount."

It is clear, especially in recent years, that an estate tax is indebtedness so that interest thereon qualifies as a deduction for the estate under 23 (b). It is also true that the tax liability imposed upon a transferee is an indebtedness. By law the transferee owes the Government money. The law makes it his obligation to make payment. It draws interest at a rate fixed by law. It has a due date. If transferee does not pay, the Government has the same means of enforcing payment which it has to enforce payment against an estate.

When an estate tax deficiency is proposed against a transferee, the transferee has the choice of paying the tax or contesting it. If he elects to retain the funds and not pay the tax until at some later time after contest and adjudication of the amount, he must pay interest on the amount that is finally determined—that is, he pays interest for the privilege of retaining an amount which constituted his indebtedness to the Government.

(c) **A transferee of an estate is a substituted taxpayer, or a substituted debtor, and an unpaid estate tax becomes the liability and indebtedness of the transferee, especially after the estate has been distributed and has no assets to pay the tax.**

Sec. 301, Revenue Act of 1926 (now Code Sec. 810) imposed a tax upon the transfer of the estate of a decedent but did not specify against whom the tax was imposed. Sec. 304, Revenue Act of 1926 (now Code Sec. 821) required returns by executor or beneficiaries. Sec. 305 (a), Revenue Act of 1926 (now Code Sec. 822 (b)) stated that the tax must be paid by the executor to the collector. Sec. 315 of

the Revenue Act of 1926 (now Code Sec. 827 (a)) provided that unless the tax was paid in full it should be a lien for ten years on the gross estate of decedent. Prior to 1926 the government proceeded against transferees under the trust fund doctrine, but this method of using a suit in equity or an action at law to enforce payment by a transferee was cumbersome and Sec. 316 of the Revenue Act of 1926 (now Code Sec. 900) was enacted to provide that the liability of a transferee of property of a decedent or donor should be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as a deficiency in the tax. This simplified the procedure of collection in that transferee was placed in the same status as the original taxpayer. It is therefore contended that the transferee becomes a substituted taxpayer with all the rights and privileges of the original estate taxpayer.

In *Phillips* vs. *Commissioner,* 283 U. S. 589, affirming 42 Fed. (2d) 177, the United States Supreme Court gives a very good discussion of liability of a transferee. The court said:

> "Stockholders who have received the assets of a dissolved corporation may confessedly be compelled, in an appropriate proceeding, to discharge unpaid corporate taxes***. Before the enactment of Section 280 (a) (1), such payment by the stockholders could be enforced only by a bill in equity or action at law. Section 280 (a) (1) provides that the liability of the transferee for such taxes may be enforced in the same manner as that of any delinquent taxpayer."
>
> "The procedure prescribed for collection of the tax from the stockholders is thus the same as that now followed when payment is sought directly from the corporate taxpayer**."

> "Section 280 (a) (1) provides the United States with a new remedy for enforcing the existing 'liability at law or in equity.' The quoted words are employed in the statutes to describe the kind of liability to which the new remedy is to be applied and to define the extent of such liability. The obligation to be enforced is the liability for the tax.***"

See also *Louisiana and Arkansas Railway Company* vs. *Commissioner*, 70 Fed. (2d) 286.

In *Routzahn* vs. *Tyroler*, 36 Fed. (2d) 208, (C. C. A. 6), the Court held that the statutory definition of "taxpayer" is not seriously inaccurate as applied to a transferee, and in *United States* vs. *Updike*, 281 U. S. 489, 496, the Court says:

> "* * * Indeed, when used to connote payment of a tax, it puts no undue strain upon the word 'taxpayer' to bring within its meaning that person whose property, being impressed with a trust to that end, is subjected to the burden. Certainly it would be hard to convince such a person that he had not paid a tax."

The transferee becomes a substituted taxpayer. He can contest the tax, appeal to The United States Board of Tax Appeals (now Tax Court) and litigate the matter through higher courts, or he can pay the tax and prosecute a claim for refund. If he does not pay the tax when finally determined, the Commissioner can assess and collect from him the amount of such liability, at law or in equity, under the same procedure as would be used against the estate. (Sec. 316, Revenue Act of 1926, now Code Sec. 900.)

If an estate tax deficiency is assessed against an estate and paid before it is distributed, such estate tax is an in-

debtedness of the estate and the interest paid thereon is deductible by the estate. If the assets are distributed without collection of the proposed deficiency and the deficiency is then asserted against the transferee, then such transferee is liable for the possibility of such tax. If after considerable negotiations and possible litigation the amount of tax is determined, then the transferee is definitely liable; certainly he would have to show such liability as an indebtedness in any correct statement of financial condition. No banker would accept a financial statement in which the legal liability for the determined amount of an estate tax deficiency was omitted or would recognize the government's contention that the estate tax deficiency was not an indebtedness of such transferee.

Estate taxes are a lien against the property of the estate and the liability for that lien follows the property into the hands of the transferee beneficiary. The interest paid by him on such obligation would be deductible the same as interest on a mortgage or mechanic's lien.

Taxpayer and his brother were the two and only residuary beneficiaries. They shared equally in the distribution of the estate; they shared equally in paying the tax and interest thereon. There was no other person to whom they could look to recoup the payment. The tax was their liability. The taxpayer had the tax imposed upon him as transferee, and under the law, his property which he received from the estate was liable for the tax and interest. The taxpayer took the place of the estate as a taxpayer. If he preferred to delay payment of tax in connection with protesting same, he had the right to do so, but any such delay made a longer

period to compute interest on his liability. The interest on the tax as finally determined was interest paid on his indebtedness, and should be allowed as a deduction in determining his net income.

John H. Hord vs. *Commissioner,* 95 Fed. (2d) 179;.

Estate of John Edgerly Morrell vs. *Commissioner,* 43 B.T.A. 651.

Boies Penrose vs. *United States,* 18 Fed. Supp. 413.

Robert P. Scripps, et al, Trustee, vs. *Commissioner,* 96 Fed. (2d) 492.

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Estate of Henderson vs. *Commissioner,* T.C. Memorandum Opinion December 14, 1943, on appeal C.C.A. 5.

Breyer vs. *Commissioner,* T.C. Memorandum Opinion January 20, 1944, on appeal C.C.A. 3.

Collins vs. *Commissioner,* T.C. Memorandum Opinion March 13, 1944, on appeal C.C.A. 9.

In the Memorandum Opinion of *Harold F. Pitcairn and Mildred G. Pitcairn, et al,* vs. *Commissioner,* issued May 22, 1944, the Tax Court had under consideration the collection of a gift tax from donees. The donees contended that the contemplated gift tax deficiency should be deducted from the amount of gift so as to reduce the amount of gift. The Commissioner argued that a donee was "personally liable for (the gift tax of the donor) to the value of such gift." The Tax Court held that there was no provision in the statute authorizing any reduction of gift on account of lien for taxes. The donee received a gift which was a separate matter from his liability for the tax. The gifts were

made prior to 1939. It will be noted that Sec. 316 (a) (1), Revenue Act of 1926, refers to the collection of the liability, at law or in equity, of the transferee of a *decedent or a donor.* If a gift tax paid by a transferee does not reduce the amount of gift, then an estate tax paid by a transferee should not reduce the distribution from the estate, as is claimed by the Commissioner in the present case.

The Commissioner in his brief, pages 7 and 8, indicates that the Tax Court in holding that a transferee was paying his indebtedness predicates its position upon Sec. 900 of the Internal Revenue Code. The Commissioner claims that this is in error as Sec. 900 imposes no liability on anyone, saying (Brief, p. 8): "It simply provides a remedy for the enforcement of a liability, if that liability otherwise exists." Taxpayer agrees with the Commissioner's apparent admission that the liability *otherwise existed.* When taxpayer became a transferee the liability for the tax was imposed upon him by operation of law. Sec. 900 provides that that liability shall be assessed, collected, and paid in the same manner as the deficiency in estate tax. If the estate had paid the deficiency and interest it would have been paying the tax, plus interest, upon its indebtedness. If the transferee pays the deficiency and interest he is paying his liability, plus interest thereon, and that interest paid upon his liability is interest paid upon his indebtedness. What is the difference between *indebtedness* and *liability* if the liability is to pay a certain sum in cash as of a certain date?

Even assuming for purposes of argument that a transferee in paying his legal liability for the amount of deficiency of estate taxes, might not be a substituted taxpayer to the

extent that he is paying the *tax* (although it would appear from Sec. 900 that such would be his status), nevertheless he is a substituted *debtor* who is under a *liability* to pay the tax. It follows that any interest necessarily paid by him because of his delay in paying such indebtedness is deductible interest under Sec. 23 (b).

It may be argued that taxpayer paid the tax voluntarily and that definite liability was not determined against him. It is submitted that he was liable under the law. Some litigation might have been had to attempt to determine a smaller amount of tax, but when the tax was determined by adjudication or by agreement, the amount was the definite liability of the taxpayer. It would be against public policy to require a person, after a satisfactory amount of tax had been agreed upon, to carry on litigation merely to get his liability reduced to judgment in order to prove that the liability imposed upon him was his indebtedness.

(d) **If the operation of law did not make the taxpayer herein a substituted *taxpayer*, but only made him a substituted *debtor*, he should still be allowed to deduct the full amount of interest paid.**

Taxpayers have often been allowed to deduct interest with respect to periods of time prior to the origin of taxpayer or assumption of indebtedness.

Columbia River Paper Mills vs. *Commissioner*, 43 B.T.A. 104, Affd. 126 Fed. (2d) 1009.

Oregon Pulp & Paper Co. vs. *Commission*, 47 B.T.A. 772, Petition for Review dismissed November 2, 1943.

Ernst Kern Co. vs. *Commissioner,* 1 T.C. 249, Petition for Review dismissed (nolle prosse) September 11, 1944.

Pressed Steel Car Co., Inc., vs. *Commissioner,* T.C. Memorandum Opinion, August 16, 1944.

The foregoing cases deal principally with reorganizations wherein a new corporation assumes debt of an old corporation, but dates the new obligations back prior to the organization of the new corporation and pays interest on those obligations from such prior date. It has been held that this prior interest is deductible as interest and does not constitute a part of the cost of acquiring properties.

In *Kern Co.* vs. *Commissioner, supra,* the Tax Court held that there was not a statutory reorganization or a non-taxable transfer and stated further upon the authority of the *Columbia River Paper Mills* and *Oregon Pulp & Paper Co.* cases that the statute does not require that the indebtedness upon which interest has accrued and become a liability of a taxpayer must be outstanding during the entire interest accrual period. In the present Green appeal the liability to the Government actually existed and was outstanding and was later assumed by the taxpayer.

It would appear that with respect to transferees of an estate the effect of the law is that there is a forced assumption of a liability arising at a date prior to the origin of status of transferee. By law this liability draws interest from the due date of the estate tax return. The transferee is forced by operation of law to assume this liability and pay interest from a date prior to becoming liable for the indebtedness. If a corporation which voluntarily agrees to assume a debt and pay interest from a date prior to the

voluntary assumption of such debt, can deduct such interest, it would appear that the same theory should apply to a transferee who has a liability forced upon him.

(e) **The liability of a transferee may be more than the value of transferred assets plus actual accumulated earnings thereon.**

The maximum amount assessable against any one transferee is the lower of the amount of (1) the amount of tax plus interest in accordance with the law to the date of assessment, or (2) the amount received in distribution plus the interest (at rates not exceeding the legal rates) from the date of transfer of property to date of assessment of tax.

Henry Capellini vs. *Commissioner,* 16 B.T.A. 802.

Wayne Body Corporation vs. *Commissioner,* 24 B.T.A. 524.

Buzard et al vs. *Helvering,* 77 Fed. (2d) 391.

Assume that a transferee receives property worth $10,000.00 and that his net earnings on this property from date of receipt to date of assessment of a transferee tax are $2,000.00, but that a fair amount of interest on the $10,000.00 at reasonable rates is $4,000.00. Assume a transferee tax of $9,800.00, plus interest of $5,000.00, or a total of $14,800.00. The transferee would then be liable for $14,000.00 of the $14,800.00, even though his transferred property plus earnings only amounted to $12,000.00. He would have to go into other earnings for the extra $2,000.00. Yet the Commissioner apparently claims that a transferee is only paying a liability of another person, and that the transferee is not personally liable.

Of course, in the present case the taxpayer does not have to go into other funds for payment of tax and interest, as the amounts received by him were in excess of the deficiency plus interest. However the question of whether or not a transferee is paying his indebtedness, or the indebtedness of an estate, or has any personal liability in connection with tax deficiency and interest, can not be made to depend upon either his individual ability or economic conditions which affect the earning power of the transferred assets, or upon the amount of transferred assets as compared with the liability imposed upon him.

(f) "Indebtedness" under Sec. 23 (b) of the Internal Revenue Code is not necessarily restricted to liabilities originated by the taxpayer, or with respect to which collection may be enforced from any property owned by him.

In several places in his brief, the Commissioner apparently denies that the estate tax liability of the transferee constituted a *personal liability or obligation* of taxpayer transferee. But under Sec. 23 (b) it is not necessary that the interest be required to be paid on a personal liability or obligation of taxpayer. The Commissioner does not define his term "personal obligation or liability." It is presumed that he claims it does not include a liability which was not originated by the taxpayer or with respect to which there is not an unlimited general obligation of taxpayer.

However, the term "indebtedness" as used in Sec. 23 (b) is broad enough to include an indebtedness which may not have arisen as an indebtedness of the taxpayer, but which

the taxpayer later constructively assumes by reason of operation of law, or some contract in which he was not a party. For a taxpayer to claim a deduction of interest paid by him which is currently accrued, it is not necessary that he be originally liable for the payment of a debt but only that he is liable for the payment when the debt is made. See *Scripps* vs. *Commissioner,* 96 Fed. (2d) 492, *Penrose* vs. *U. S.,* 18 Fed. Supp. 413, *New McDermott, Inc.,* vs. *Commissioner,* 44 B.T.A. 1035.

It is possible that when a transferee pays an estate tax deficiency he may not be paying a tax which would be deductible in ascertaining net income if estate taxes were allowed as an income tax deduction, which they are not, but there is no attempt herein to deduct the tax. Taxpayer requests only the deduction of the interest paid on this liability.

Sec. 315 (b) of the Revenue Act of 1926 contained a provision wherein certain classes of transferees (arising before death of decedent) including beneficiaries of insurance policies became personally liable for the tax to the extent of their interest in transferred property if the estate tax was not paid. Presumably this was because of difficulty of enforcing liability and collection by suits involving trust fund doctrine. This section was reenacted as Sec. 827 (b) of the Code, and Sec. 827 (b) of the Code was amended by Sec. 411 (a) of the Revenue Act of 1942 so that it read as follows:

> "Liability of Transferee, etc.—If the tax herein imposed is not paid when due, then the spouse, transferee, trustee, surviving tenant, person in possession of

> the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under Section 811 (b), (c), (d), (e), (f), or (g), to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax. * * *"

The report of the House Committee on Ways and Means, Cum. Bull. 1942-2, 372, 495, indicates that the new section clarifies and consolidates provisions of the law. The old section 827 (b) of the Code imposed personal liability for transfers in contemplation of death or to take effect at or after death, but all of the assets in Sec. 811 were treated equally for inclusion in the gross estate, and the holders or recipients of such assets were accordingly placed on the same plane of personal liability for the tax.

It would appear that the imposition of personal liability on transferees who were distributees of an estate presented no new or radical departure in the law. They were already liable at law or in equity for the tax to the extent of the value of property transferred at date of death.

In *Fox* vs. *Commissioner*, 43 B.T.A. 895, petitioner's husband had in a prior year assigned certain life insurance policies to her. The husband had previously borrowed on the policies and overdue interest had been added to the loans. During the taxable year under consideration the petitioner had paid old interest and current interest. The Commissioner had disallowed that portion of interest which accrued prior to the date of assignment, but had allowed deduction for interest accruing after date of assignment, notwithstanding the fact that the husband and not the petitioner

was the maker of the loans. The Board of Tax Appeals sustained the Commissioner. The Commissioner in his present brief, page 7, states that there is only one situation in which a deduction is allowable to one who is not personally liable on a principal debt, namely where the owner of property subject to a mortgage pays the interest on the mortgage. It is submitted that in the *Fox* case the Commissioner himself allowed one who was not personally liable on a principal debt to deduct interest from date of transfer and did not contest her right to do so. He only objected to the deduction of payments of amounts accumulated as interest prior to date of transfer. In other words, in *Fox* vs. *Commissioner* the Commissioner himself took the identical position now taken by the Tax Court in the decision from which the Commissioner is appealing!

Suppose a taxpayer acquires property from an estate on which there had been a mechanic's lien for repairs. The lien is primarily enforceable only against the property, but it is the indebtedness of the transferee's property and he is secondarily liable. He must pay the indebtedness or suffer loss of property. The payment of the principal amount of repairs may not be deducted by taxpayer as repairs as it would be an additional cost of property, but the interest paid on such liability or indebtedness, especially the amount accruing since date of transfer, is an interest deduction for such taxpayer. Another illustration would be property taxes imposed against property before date of transfer. The principal of taxes might not be deductible as *taxes,* but would be a capital item as differentiated from expenses, but

the interest on the delinquent taxes caused by taxpayer's delay in payment would be deductible interest.

Another common illustration is a real estate mortgage against an acquired property. Assume that in the present case taxpayer had received in distribution of his father's estate a tract of real estate against which there was a mortgage of $10,000.00. The mortgage would not be a direct personal liability of transferee taxpayer, but it would be his indirect indebtedness because of being a lien against his land. It has always been clear that such interest paid or accrued subsequent to transfer would be an allowable deduction for transferee, except, possibly, the amount of interest that accrued prior to date of transfer. The transfer of an equity in mortgaged property is so common an occurrence that the Commissioner has for many years had a regulation allowing the owner of real estate to deduct interest on a mortgage indebtedness for which the taxpayer was not originally directly or personally liable. Sec. 29.23 (b)—1 Reg. 111. This portion of the regulations shows that a taxpayer can deduct interest in connection with a lien against property owned by him and the regulations do not specifically limit the deduction of such interest to the lien of a real estate mortgage. The theory applies to a chattel mortgage or any other form of lien or indebtedness against the property of a taxpayer even though the taxpayer may not have personally caused such liability to arise and although his liability may be limited to the recourse of creditor against the specific property. It appears that the interest on all such indirect liabilities has been consistently allowed by the Commissioner as a deduction, with the single exception

of interest with respect to a lien for federal taxes against the property of a transferee.

(g) **Taxpayer was executor of father's estate and as such he was personally liable under Sec. 3467 R.S. in addition to being liable as a transferee.**

The Commissioner, in his brief, tries to show that there was no personal liability for estate tax deficiency in connection with being a transferee. Sec. 3467, Revised Statutes, provides that every executor who paid any debt of the estate without paying debts to the United States from the estate "shall become answerable in his own person and estate" for the amount of debts due to the United States. As hereinabove pointed out such personal liability is not necessary to make the estate tax deficiency an indebtedness under Sec. 23 (b), but if such personal liability is necessary, then the taxpayer in this case had such personal liability.

(h) **Taxpayer was reporting on a cash basis and should deduct full accrual of interest when paid.**

The Tax Court held that taxpayer could only deduct the interest which accrued after the date he became transferee. In this particular case practically all of the interest pertained to the period after distribution of the estate. The amount accruing for the period between the date when the estate tax should have been paid and the date of distribution of estate is only nominal. It is contended on behalf of taxpayer, however, that the full amount of interest paid should have been allowed as a deduction.

If a taxpayer assumes an indebtedness of a vendor in

connection with acquiring property, it is true that the interest which might be accrued at date of assumption of such indebtedness constitutes purchase of property for taxpayer and can not be deducted as interest under Sec. 23 (b) regardless of whether taxpayer was on cash or accrual basis. But the reason for this rule is that under fixed legal and accounting principles the interest accrues proratably over a period of time. With respect to federal tax deficiencies or refunds, however, the interest does not accrue proratably over a period of time, but accrues within the taxable year when the amount of deficiency is finally adjudicated or agreed upon or within the year when the certificate of overassessment is issued by the Commissioner.

I.T. 3491, 1941-2 C.B. 177.

G.C.M. 9575, X-1 C.B. 381.

Street & Smith Publications, Inc., vs. *U. S.,* 38 Fed. Supp. 461.

I.T. 2210, IV-2 C.B. 43.

The present taxpayer returned his net income on the cash receipts and disbursements basis instead of accrual, and it would appear that the discussion of accrual of interest on estate tax deficiency is not pertinent to the present case because he was on a cash basis and could take the full amount as a deduction in the year when paid.

(i) **Interest received by a transferee with respect to a refund of estate taxes would be taxable income of transferee, and not receipt of non-taxable principal of estate; the same rules should govern the payment of interest upon a deficiency.**

Interest paid on indebtedness is a deduction. Interest received is income. In connection with the question of the status of interest paid by a transferee in connection with a deficiency of estate taxes, it might be pertinent to consider the status of interest received by a transferee in connection with the refund of an overpayment of estate taxes originally paid by the estate.

The Commissioner contends that whenever a transferee pays the liability imposed upon him for estate tax deficiency and interest, that he is not paying his indebtedness and has no deduction for interest, but is paying an indebtedness of the estate which constitutes in entirety a reduction of his distribution received from estate. To be consistent, in connection with a refund of estate taxes and interest, the Commissioner would be obliged to rule that the transferee was receiving assets of the estate in the amount of both principal and interest as an additional distribution from the estate, which additional distribution would be a non-taxable receipt to transferee, both with respect to principal and interest. We have been unable to find any such ruling. Apparently it is so obvious that the interest is taxable income to the transferee that no question has arisen.

It is submitted that in the case of a refund the Commissioner would contend that the transferee was taxable on the interest, either (a) as an earning on the assets of the right to claim a refund distributed to him in settlement of estate, or (b) that under the trust fund doctrine the interest was first constructively received by a somewhat dormant trust, and was then constructively distributed to taxpayer transferee, and then became taxable income for transferee.

In this connection it has been ruled, and the ruling consistently followed, that interest in connection with a refund of federal taxes constitutes taxable income in the year when received for a taxpayer on the cash basis, and in the year when the certificate of overassessment is issued for taxpayer on the accrual basis. The accrual occurs at the time certificate for overassessment is issued. I. T. 2210, IV-2 C.B. p. 43 issued in 1925. On this principal interest paid is an allowable deduction.

II.

ON THE TRUST FUND THEORY THE GROSS INCOME OF TAXPAYER SHOULD BE REDUCED BY THE AMOUNT OF INTEREST PAID WITH RESPECT TO THE ESTATE OR ANY TRUST ARISING FROM DISTRIBUTION OF THE ESTATE.

(a) **If, under the so-called "trust fund doctrine" a transferee taxpayer, when paying an estate tax deficiency and interest, is only paying the liability of the estate instead of his indebtedness and interest, and therefore can not deduct the interest himself, then the taxpayer's gross income for 1939, derived from the trust of properties transferred from the estate, should be reduced by the interest paid for the estate in 1939.**

The Commissioner apparently contends that the taxpayer transferee, when paying liability imposed upon him with respect to taxes originally assessable against transferor, is

paying a debt of transferor out of funds or property received by transferee from transferor.

Under the so-called "trust fund doctrine," when a transferee receives property, the property is impressed with a trust in favor of any creditors, disclosed or undisclosed, of the transferor. This trust, however, remains dormant or inert unless and until some creditor of transferor makes a claim under the trust fund doctrine against the transferee. The trust then comes into action to provide equitable relief for the creditor of transferor.

Under income tax laws, if the income of a trust is accumulated for later distribution, an income tax is imposed for that year upon the trust, but if the income is distributed, the tax upon such distributed income is imposed upon the persons receiving such distribution. It would therefore appear that under the trust fund doctrine the transferee holds the transferred property in trust and receives the income from it just the same as if no trust fund existed as long as no creditor brings the trust fund doctrine into action. If and whenever a creditor uses the trust fund doctrine and the transferee "disgorges" (to use the phrase adopted in the Commissioner's brief), there is a payment of principal and interest of debt of the trust. Under federal income tax laws regarding taxation of trusts, the interest would be deductible by the trust from any income received by the trust. If transferee held transferred assets impressed with the trust with respect to which gross income of $15,000.00 was received in the taxable year, and if in the same taxable year $5,000.00 of interest deduction was paid for the trust then the transferee would receive distribution of taxable

income from the trust in the amount of $10,000.00, and not $15,000.00.

In the present case some of the properties received by transferee from his father's estate had been sold and proceeds converted into other investments and the gross income from the transferred assets or substituted assets was far in excess of the amount of interest paid with respect to the tax deficiency. The dividends received by taxpayer in 1939 from capital stock of one corporation, which was received by taxpayer from his father's estate and had been continuously held by him through 1939 was almost double the amount of designated interest paid with respect to estate tax deficiency. (R. 42)

If the Commissioner's contentions are sustained that under the trust fund doctrine taxpayer was paying debt and interest of the trust which arose by the distribution of the estate, then it is contended that taxpayer should not include in the gross income all of the gross income received by properties impressed by the trust, but that there should be deducted from such gross income the interest paid in 1939 for the trust, and therefore in 1939 taxpayer's distributable share of income from the trust was $4,143.00 less than the amount which was included in gross income.

This allegation of error was raised before The Tax Court in an amended petition (R. 18).

The reduction of the amount of gross income by amount of interest paid will, of course, reduce the net income. There appears to be no question that $4,143.00 interest was paid on an indebtedness. If this indebtedness was the indebtedness of taxpayer then he is entitled to the deduction of the

amount of interest paid. If the interest was paid on indebtedness of a trust, then the gross dividend income constructively received by taxpayer from trust property would be reduced by the amount of the interest.

The Commissioner, in his brief, relies considerably on *Koch* vs. *U. S.,* 138 Fed. (2d) 850. In that case the stockholders of a dissolved Kansas corporation paid an income tax deficiency plus interest computed upon the corporation net income. The court indicated that the tax and interest was paid, not from their own funds, but with assets of the corporation held by them as trustees, and to which the Government, as a creditor, had a prior claim. In discussing *Penrose* vs. *U. S.*, 18 Fed. Supp. 413, the Court indicated that if Koch and the other stockholders had paid the interest out of income derived from assets transferred from the corporation or if they were asserting that they did not realize income as dividends in 1931 from the assets of the company distributing them to the extent that such assets were used to pay liabilities of the company, then the *Penrose* case might apply, but that the record in the *Koch* case presented no such issue.

In the present Green case, if the interest was paid by taxpayer out of the trust, then the payment of such interest reduces the amount of income constructively received from the assets held by the trust.

It may be of interest to note that in *Koch* vs. *U. S., supra,* the Court said: "Where the trust property has been used by the stockholder for his own purpose, or disposed of by him, he may be held *personally liable* for the full value thereof." (Emphasis supplied.) In the present Green case there was an intermingling of estate assets with other personal assets

and the capital stock of one corporation had been sold and proceeds reinvested, but there remained the capital stock of another corporation received from the estate, the income from which was much in excess of the interest payment in controversy. From the statements of the Court in the *Koch* case, it would appear that under some conditions a transferee could become personally liable for an indebtedness of the transferor carried over against the trust. If the Commissioner should contend that the taxpayer has taken over the assets of the trust fund to such extent that the trust fund has been depleted, the transferee taxpayer would be liable for the full value thereof as indicated by the court in *Koch* vs. *U. S. supra,* and citations given therein including *McWilliams* vs. *Excelsior Coal Company,* 298 Fed. 884 (C. C. A. 8).

In the event the question should arise as to whether or not the trust income and deductions should be considered on the cash or accrual basis to determine the amount of net income constructively distributed to taxpayer and taxable to him, it is contended that it does not make any difference whether cash or accrual basis is used. The income of dividends received from stock of one corporation would be taxable in 1939 and that income alone was considerably in excess of the interest deduction without even considering other income that might have come to taxpayer impressed with the taint of trust fund. Regarding deductions, on an accrual basis, the interest on deficiency did not accrue until the deficiency was determined by agreement in 1939. Considered from a cash receipts and disbursements basis, it was *paid* in 1939. Under either method the interest would be a deduction.

If the trust fund doctrine is accepted the *entire amount* of

interest would be taken into consideration as a reduction of gross income constructively received from the trust and there would be no prorating of interest with respect to periods before and after the date taxpayer became a transferee.

The estate tax deficiency was an indebtedness and the interest paid thereon should be an allowable deduction for some person. If, by the operation of the law, a trust existed to such an extent that the interest could be deducted only by the trust, then the income from properties of the trust should be passed through the trust and be reduced by the interest deduction before being taxable income for the beneficiary of the trust.

CONCLUSION

Either the taxpayer paid interest on his own indebtedness or else under the trust fund theory the gross income with which he is charged should be reduced by the interest paid for the estate in 1939. On either theory the taxpayer is entitled to an allowance for the interest paid.

Respectfully sumbitted,

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